Financial Risk Mitigation Senior Task Force Liquidation Discussion, Part II

Nigeria Bloczynski
Chief Risk Officer
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Financial Risk Mitigation Senior Task Force

Agenda

- Purpose
- Background
- Research & Best Practices
- Considerations
  - Impact to remaining FRMSTF work
  - Path forward

Purpose

Re-establish the ability for PJM to liquidate defaulted FTR open positions in a prudent and practical manner, while providing flexibility in the way it exercises the right, including but not limited to closing out, auctioning off portions of the portfolio across several regular auctions, and/or conducting one or more special Financial Transmission Right (FTR) liquidation auctions.

Background

- In 2009, PJM implemented changes to its Tariff and Operating Agreement initiating the practice of liquidating a defaulting FTR Participant's forward month (open) Financial Transmission Right (FTR) positions.
- This change resulted in requiring PJM to follow a set of rigid instructions on how to liquidate a defaulted FTR Participant's open FTR positions, instead of carrying them to settlement.
- In December, 2018, PJM implemented changes to its Tariff and Operating Agreement ending the practice of liquidating a defaulting FTR Participant's open FTR positions.
- This change resulted in requiring a defaulted FTR Participant's FTR open positions to go to settlement, rather than being liquidated.

Research and Best Practices

ISO practices on Liquidation

- 3 out of 4 ISOs that responded to our query, do not currently have the ability to liquidate portfolios and carry all defaults to settlement.
- ERCOT is currently undergoing revisions to their liquidation process

Financial Derivative Standard Market Practices on Liquidation

- Minimize losses for non-defaulting participants;
- Limit significant price disruptions to the market;
- Manage and close out the defaulting participant’s positions and liquidating, in a **prudent and orderly manner,** while considering the following factors.
  - Liquidity of the market
  - Volatility
  - Size of the portfolio
  - Other market factors

Industry Focus Shift

- Defaults on exchanges that occurred in the last 5 years has put focus on implementing risk management practices.
- Several papers published - highlighting the need to implement <u>consistent</u> risk management practices, including, but not limited to:
  - Onboarding criteria and creditworthiness standards
  - Effective risk controls and processes
  - Effective default management practices
  - Margining requirements

CCP Best Practices – CCP12 Position Paper

- The CCP12 paper lays out that a CCP (Central Counterparty) must:
  - have the necessary flexibility to manage a default considering its unique circumstances;
  - be able to act swiftly to manage…and react to the event in a manner that best supports the stability of the broader financial system; and
  - be able to structure the auction and/or liquidation…given the circumstances of a default.
- Therefore, prescriptive requirements for a CCP to address (defaults) are inappropriate and could in fact undermine the CCPs ability to effectively mitigate the risk of the event.[1]

[1] https://ccp12.org/wp-content/uploads/2019/05/CCP-Best-Practices__CCP12_Position_Paper.pdf

CPMI-IOSCO – A discussion paper on central counterparty default management auctions – June 2019

- When considering the establishment and communication of the elements of default management auctions, as well as the associated governance arrangements, CCPs generally consider it important to have discretion to exercise flexibility when conducting a live auction.
- In the event of an unsuccessful auction, a CCP has the option to consider either rerunning the auction or using other default management or recovery tools. A CCP may take into consideration the following when determining next steps:
  - the financial soundness of itself and its non-defaulting participants;
  - prevailing market conditions, especially liquidity and volatility; and
  - the broader financial system[2]

[2] https://www.bis.org/cpmi/publ/d185.pdf

Impact to Initial Margining Discussion

- The holding period of the underlying assets are a direct input into the initial margin calculation.
- Requiring a defaulted portfolio be held to settlement introduces volatility impacting the amount of initial margin required, depending on the size of the portfolio and other factors.
- To facilitate and reach consensus regarding the Initial Margin requirements a default management process needs to be defined.

Considerations

Summary

- Reinstating the waived language does not allow for flexibility and confines the process to prescribed steps
- Maintaining status quo does not allow for any risk mitigating actions and can keep positions open for years in the future
- Refining the language to allow for flexibility will provide a default management process that can effectively mitigate the risk of a defaulted portfolio in a prudent and orderly fashion
- Consensus on this topic will facilitate continued discussions, specifically around IM

Path Forward

- Move default management forward as a separate filing in advance of the rest of the items being discussed in this phase of the FRMSTF.
  - Given the dependency of initial margining on the type of default management that is in place, it is beneficial to have the default management piece determined before finalizing an initial margining approach.
  - Allows time for the task force to focus on the more complicated issues related to initial margining and the remaining credit requirement components.

References

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Contact

Facilitator:
Anita Patel,
Anita.Patel@pjm.com

Secretary:
Michele Greening,
Michele.Greening@pjm.com

SME:
Nigeria Bloczynski,
Nigeria.Bloczynski@pjm.com

FRMSTF

Member Hotline

(610) 666 – 8980

(866) 400 – 8980

custsvc@pjm.com